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International financial system and development

Report of the Secretary-General**

Summary

The present report, submitted in response to General Assembly resolution 65/143, complements the report of the Secretary-General on the follow-up to and implementation of the Monterrey Consensus and the Doha Declaration on Financing for Development. It reviews recent trends in international official and private capital flows of developing countries and current efforts to reform the international monetary and financial system and architecture. The report highlights the urgent challenges arising from the world financial and economic crisis and its aftermath, in particular in the key areas of financial regulation and supervision, multilateral surveillance, macroeconomic policy coordination, sovereign debt, a global financial safety net, the international reserve system and governance reform of the Bretton Woods institutions.

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** The present report was prepared in consultation with staff from the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations Secretariat.

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I. International financial flows of developing countries

A. Global imbalances and reserve accumulation

1. Persistent global imbalances can be seen as a manifestation of an increasingly interdependent global economy. They refer to the pattern of large persistent current account deficits in the United States and, to a lesser extent, some other advanced economies in Europe, matched by surpluses in emerging economies, most notably China, as well as in Germany and Japan.

2. The recent global recession led to a narrowing in global imbalances with the external deficit of the United States declining from its peak of 6 per cent of gross domestic product (GDP) before the recession to a low of 2.7 per cent in 2009, while China's surplus dropped from a high of 10 per cent of GDP to 6 per cent in the same period. The current account surpluses of Germany, Japan and some energy-exporting emerging economies were also reduced. However, there are signs that global imbalances are beginning to widen again along with the global recovery. In 2010, the current account deficit of the United States increased slightly to above 3 per cent of GDP, while the surpluses of Germany, Japan and the energy-exporting countries widened. However, the current account surplus of China, as a percentage of GDP, declined further to about 5 per cent.[1] How these adjustments play out over the coming year would be influenced by, among other things, trends in growth rates, levels of domestic demand in key economies, sovereign debt problems, and movements in exchange rates.

3. The unprecedented accumulation of foreign reserves by a number of developing country central banks is a central component of the widening of global economic imbalances. Following the emerging market crises of the 1990s, a number of developing countries, especially in emerging Asia, accumulated vast amounts of foreign currency reserves as a form of self-protection against future crises. The reserve accumulation was associated with an undervaluation in the currencies of some of these countries and the generation of current account surpluses. This in turn contributed to widening current account deficits in economies like the United States of America. A vicious cycle resulted whereby the subsequent flow of finance from these surplus economies into deficit countries like the United States contributed to the build-up of asset bubbles within them leading to a further widening of global imbalances that entailed even greater financial flows from deficit to surplus countries.

4. The strategy of international reserve accumulation helped emerging market economies during the crisis, when a number of them used these reserves to moderate currency volatility, offset shortages in dollars faced by local markets and create fiscal space. Indeed, during the trough of the crisis, in the last quarter of 2008 and early 2009, the tapping by developing countries into their surplus reserves led to an aggregate fall in reserve holdings by about $300 billion. The recovery of exports and the subsequent return of capital flows facilitated renewed growth of reserve holdings. Reserve holding by developing countries and economies in transition totalled about $5.4 trillion at the end of 2009, to which an additional $500 billion was added in 2010. A large proportion has been accumulated by developing

[1] See *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.11.II.C.2); see also E/2011/113.

countries in Asia, particularly China, which was holding about $2.6 trillion in foreign-exchange reserves at the end of 2010.[2]

5. Looking ahead, emerging economies are expected to continue to accumulate reserves as a form of self-protection against financial shocks. The effective use of reserves during the recent financial crisis in warding off financial instability, as well as the fact that a number of developing countries experienced capital outflows during this period, has re-emphasized the importance of having an insurance mechanism during periods of economic turbulence. Moreover, the likelihood that countries will, in the near future, have immediate access to a sufficient amount of foreign currency finance in the event of a major crisis seems slim.

B. Private capital flows to developing countries

6. The last couple of years have witnessed a strong revival in private capital flows to emerging economies, following the sharp downturn that took place during the recent global economic and financial crisis. Net private capital flows to developing countries are estimated to have risen from about $325 billion in 2009 to about $392 billion in 2010.[3] This has been driven by a combination of circumstances. Most importantly, stronger growth and higher interest rates in developing countries has attracted investors, especially when compared with sluggish economic prospects and low interest rates in a number of advanced economies. In addition, the relative risk characteristics of advanced and emerging economies favour the latter, given continuing fiscal and public debt problems in some developed countries, especially in Europe.

7. Foreign direct investment remains a major component of private capital flows to developing countries and is estimated to have amounted to over $300 billion in 2010.[3] While FDI flows have, like other components of private capital flows, been concentrated in selected developing countries, there are signs of greater diversification. Foreign investment in Africa, though flat over the past year, is significantly higher than a decade ago. While a large portion of these flows are continuing to go into the natural resource sector, and to some commodity-rich countries, the region has also been attracting foreign direct investment into agriculture and new service sectors such as banking and telecommunications.

8. Other components of private capital flows to developing countries, including international bank lending and portfolio investments, have continued their path of recovery following the crisis. Cross-border bank lending nevertheless remains weighed down by continuing financial difficulties faced by advanced country banks. These have been particularly acute in the transition economies in Europe and Asia and have served to restrain lending to these regions. However, according to statistics provided by the Bank for International Settlements, cross-border lending to emerging Europe has recently begun to expand for the first time in two years.[4] A large share of the increase in cross-border lending to emerging markets has been

[2] *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.11.II.C.2).

[3] International Monetary Fund, World Economic Outlook Database, April 2011, available from www.imf.org.

[4] Bank for International Settlements, *Quarterly Review*, 14 March 2011, available from www.bis.org.

directed towards rapidly growing economies of the Asia-Pacific region, especially China, and Latin America, where Brazil has accounted for a large proportion of international bank loans.

9. Portfolio capital flows also staged a recovery in the aftermath of the crisis and have been directed mainly towards middle-income emerging economies, particularly in Asia and Latin America. The upturn in portfolio flows has been reinforced by low interest rates in the advanced economies, as well as concerns about economic fundamentals in some of these countries, that have led investors to be more favourably disposed towards emerging markets. Equity flows to developing countries were particularly strong in 2010 and stock markets in developing countries have regained much of the value lost during the crisis. Equity issuance rose to historically high levels in some countries, especially Brazil and China, and was buoyant in other emerging economies such as the Republic of Korea and India. The recovery in portfolio debt inflows has also triggered strong issuance of corporate debt in a number of emerging markets, especially in Latin America. International Monetary Fund (IMF) statistics suggest that the aggregate supply of external corporate bonds reached a historical record in 2010.[5]

C. Official development assistance

10. In 2010, total net ODA[6] from the Organization for Economic Cooperation and Development's (OECD) Development Assistance Committee (DAC) member countries reached $129 billion, the highest level ever, representing 0.32 per cent of DAC members' combined gross national income (GNI).[7] Net bilateral ODA to Africa was $29 billion, an increase of 4 per cent in real terms over 2009, of which $27 billion went to sub-Saharan Africa (an increase of 6 per cent). Net ODA/GNI ratios of many large donors are below the internationally agreed target of 0.7 per cent, while five countries (Denmark, Luxembourg, the Netherlands, Norway and Sweden) continue to exceed that target. Although aid delivery to least developed countries increased from $12 billion in 2000 to $37 billion in 2009, the improvement of DAC member countries' aggregated ODA/GNI ratio (from 0.05 per cent to 0.10 per cent) was not sufficient to achieve the least developed country

[5] International Monetary Fund, *Global Financial Stability Report: Durable Financial Stability: Getting There from Here* (Washington, D.C., April 2011).

[6] Net ODA is equal to gross ODA disbursements minus amounts received (e.g., repayments of principal, offsetting entries for debt relief, repatriation of capital and recoveries on grants) from countries and territories in the DAC list of ODA recipients. Interest payments are not deducted. Although most ODA data are expressed in "net ODA" terms, "Net Aid Transfers" (NAT), which deduct cancellations of non-ODA loans and interest payments from net ODA, are regarded as a better measure in two accounts. Firstly, NAT is net of both principle and interest payments on ODA loans, which is particularly relevant for some donors receiving a large amount of interest on ODA loans. Secondly, NAT excludes cancellations of old non-ODA loans because cancellations of such loans hardly generate additional net transfers, even though it is counted as ODA. According to the NAT data sets (Center for Global Development, Net Aid Transfers data set, available from www.cgdev.org), the 2009 NAT was $112 billion compared to the net ODA of $120 billion.

[7] Organization for Economic Cooperation and Development, "Development aid reaches an historic high in 2010", 6 April 2011, available from www.oecd.org.

target of 0.15-0.20 per cent. To reach the lower limit of this target, DAC donors need to increase their net ODA by 1.5 times of the current level to $58 billion.[8]

11. Net ODA disbursements of all major DAC donors rose in 2010. The United States, the largest donor, increased its ODA by 3.5 per cent in real terms and exceeded $30 billion (0.21 per cent of GNI). Its bilateral aid to LDCs reached a record high of $9.4 billion, an increase of 16.2 per cent from 2009, of which $1.1 billion was allocated to Haiti in the aftermath of the 2010 earthquake. ODA from the 15 DAC-EU members also rose by 6.7 per cent and exceeded $70 billion, accounting for 54 per cent of the total DAC ODA. The DAC/European Union ODA/GNI was 0.46 per cent, compared to 0.44 per cent in 2009. Although Japan fell $3.6 billion short of its promise made at the 2005 Group of Eight (G-8) Summit in Gleneagles to increase its ODA by $10 billion over the period 2005-2009, the net ODA from Japan increased, in 2009-2010, by 11.8 per cent in real terms to $11 billion. This was mainly owing to the country's larger bilateral grants to least developed countries and a major contribution to the World Bank. Its ODA/GNI ratio improved from 0.18 per cent in 2009 to 0.20 per cent in 2010.[9]

12. Despite the increase in the volume of aid, the 2010 overall ODA delivery fell short by $21 billion of the pledges made at the 2005 G-8 Gleneagles Summit. The shortfall regarding Africa was $18 billion. With respect to the ambitious European Union ODA/GNI target of 0.51 per cent set for 2010, about half (8 out of 15) of the DAC/European Union members have met this goal. One country (France, with a ratio of 0.50 per cent) nearly met the goal, but others fell short with ratios ranging from 0.15 to 0.43 per cent.[10]

13. The outlook for aid beyond 2010 is not promising. OECD estimates that the global country programmable aid[11] would increase at a real rate of 2 per cent from 2011 to 2013, compared to an average of 8 per cent in the past three years.[9] Most of the increase is coming from multilateral donors. OECD projects that country programmable aid to Africa will increase by 1 per cent annually in real terms. Country programmable aid to least developed countries is projected to grow by 5 per cent in 2010 and 3 per cent in 2011 but stagnate in 2012.[8]

14. Innovative sources of financing are expected to provide "additional" resources to supplement traditional sources of development finance. However, the vast majority of revenues raised through the existing innovative financing mechanisms are recorded as ODA, as they are raised under national legislations.[12] Accordingly, what is counted "additional" in relation to ODA is the contribution of the non-official sector (e.g. private philanthropy). For instance, in the health sector, of

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[8] Development Cooperation Forum, "Background study for the 2012 Development Cooperation Forum: trends in international financial cooperation for LDCs", draft 29 April 2011, available from www.un.org.

[9] See Organization for Economic Cooperation and Development, "Development: Aid increases, but with worrying trends", 6 April 2011, available from www.oecd.org.

[10] OECD, "Development aid reaches an historic high in 2010", 6 April 2011, available from www.oecd.org.

[11] Country programmable aid is the portion of aid that each donor can programme for each recipient country. It reflects more predictable flows of aid that are available for recipient country planning and spending according to national priorities.

[12] Organization for Economic Cooperation and Development Working Party on Statistics, "Mapping of some important innovative finance for development mechanisms", 7 February 2011, available from www.oecd.org.

the $5.5 billion raised by selected innovative financing mechanisms since 2002 only about $0.2 billion is "additional to ODA", according to OECD statistics.[12] Yet, even these "additional" resources may be reported as ODA when they are disbursed by DAC multilateral donors.

15. In the health sector, where operational mechanisms are concentrated, the Leading Group on Innovative Financing for Development estimates that nearly $6 billion has been raised by the operational mechanisms.[13] While discussions on the innovative finance for education, food security and other sectors at various forums are under way, the G-8 Muskoka Initiative on Maternal, Newborn and Under-Five Child Health and the United Nations Global Strategy for Women's and Children's Health may facilitate the scaling up of the existing mechanisms or implementation of new ones (e.g., tobacco tax) to fill the annual funding gap of $26 to $42 billion in the period 2011-2015 in the health sector.[14]

16. As the 2015 deadline of the Millennium Development Goals approaches, expectations regarding the potential of innovative mechanisms in financing development have increased. Fiscal constraints aggravated by the global economic crisis have renewed the interest in innovative finance and some specific mechanisms (e.g., financial transactions tax). The Leading Group on Innovative Financing for Development estimated that a centrally collected multi-currency transaction tax could generate $25 to $34 billion annually (at the rate of 0.005 per cent) to help meet the funding needs for international development and environmental challenges.[15]

17. To meet the annual commitment of $100 billion under the Copenhagen Accord, financial transaction taxes were also examined by the Secretary-General's High-level Advisory Group on Climate Change Financing.[16] This Advisory Group has concluded that auctions of emission allowances and new carbon taxes in developed countries have the greatest potential among the new public instruments examined, by generating $30 billion annually. Another $10 billion a year could be raised from taxing carbon emissions from international (maritime and aviation) transportation, and up to $10 billion could be mobilized from some form of financial transaction tax implemented among interested countries at the national or regional levels.

II. Strengthening the international financial architecture

A. Reform of financial regulation

18. A major step in the reform process triggered by the financial crisis is the introduction of the Basel III framework for bank capital and liquidity regulation. Following the endorsement by the G-20 leaders at the November 2010 summit, the

[13] The Leading Group Secretariat, "Leading Group Task Force on Innovative Financing for Health: Terms of Reference", available from www.leadinggroup.org.

[14] Secretary-General Ban Ki-moon, "Global Strategy for Women's and Children's Health", 2010, available from www.who.int.

[15] Leading Group on Innovative Financing for Development, "Globalizing Solidarity: the Case for Financial Levies: Report of the Committee of Experts to the Taskforce on International Financial Transactions for Development", 2010, available from www.leadinggroup.org.

[16] United Nations, "Report of the Secretary-General's High-level Advisory Group on Climate Change Financing", 5 November 2010.

Basel Committee on Banking Supervision issued the Basel III rules text on 16 December 2010. Now it needs to be transposed into national law and applied according to the agreed schedule. To minimize the transition costs, the Basel III requirements will be phased in gradually starting from 1 January 2013, so that they can be fully implemented by 1 January 2019.

19. Compared to its predecessors, Basel I and II, Basel III attempts to be more comprehensive in scope. It provides for higher minimum capital requirements, better risk capture, a stricter definition of eligible capital elements and larger liquidity buffers. In addition, the framework combines micro- and macroprudential elements to address both institution and systemic risks.[17]

20. One goal of Basel III is to create a globally consistent and harmonized regulatory structure as a way to ensure a level playing field. It is thus considered important to discourage competitive race to the bottom and beggar-thy-neighbour policies that might benefit narrow national interests at the expense of global financial stability. At the same time, given diverse national structures, the challenge is to strike the right balance between ensuring an international level playing field and accommodating country differences in order not to place unnecessary burden of adjustment on national financial systems. Repercussions of Basel III on access to financing for low-income countries should also be taken into account, including possible adverse impacts on trade finance.

21. The fallout from the crisis underscores the need to put in place additional measures to reduce the likelihood and the severity of problems emerging at systemically important financial institutions. Accordingly, in addition to the Basel III standards, an international effort is under way to reduce the probability of failure for systemically important financial institutions and, in case a failure still occurred, to limit its impact on the financial system as a whole.

22. It has been agreed within the G-20 that systemically important financial institutions, and initially in particular global systemically important financial institutions, should have loss-absorbing capacity beyond the general standards promulgated by the Basel III rules, as well as more intensive supervision to reflect the greater risks that these institutions pose to the global financial system. The additional capital charges are also thought to be able to level the playing field by reducing too-big-to-fail competitive advantages in funding markets.

23. Work is currently under way on how to define institutions that are systemically important based on criteria such as size, interconnectedness and substitutability, and how to determine the capital surcharges, contingent capital and other elements to limit systemic fallout. The Financial Stability Board, in consultation with the standard setters, will recommend the additional degree of loss absorbency and the instruments by which it can be met by end-2011.[18]

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[17] For an overview of Basel III, see, for instance, "Basel III: Stronger Banks and a More Resilient Financial System" by Stefan Walter, Secretary General, Basel Committee on Banking Supervision, at the Conference on Basel III, Financial Stability Institute, Basel, 6 April 2011, available from www.bis.org.

[18] Financial Stability Board, "Progress in the Implementation of the G-20 Recommendations for Strengthening Financial Stability: Report to G-20 Finance Ministers and Central Bank Governors", 15 February 2011, available from www.financialstabilityboard.org.

24. The Financial Stability Board is also working to set out the essential features and tools that national resolution regimes for failed systemically important financial institutions should have in order to avoid a chain reaction which could eventually lead to a systemic crisis.[18] Supervisors from different countries are working together in an effort to create more effective cross-border crisis management tools and resolution regimes. This work, however, is in its very early stages and there are still significant obstacles to overcome.[19]

25. Another important issue is integrating into the regulatory framework the so-called shadow banking system; i.e., credit intermediation through non-bank channels. In this context, there is a need to ensure that tighter regulatory rules on banks do not provide incentives for financial institutions to shift their activities to unregulated areas.

26. The challenge is to establish an appropriate definition of shadow banking and outline possible regulatory measures to address the risks posed by this sector. The Financial Stability Board is currently discussing all the options regarding the definition, the monitoring and the regulation of the shadow banking sector. In April 2011, it published a background note on shadow banking.[20] The note sets out the current thinking on the issue and proposes that monitoring and policy responses should be guided by a two-stage approach: firstly, by casting the net wide to cover all non-bank credit intermediation so as to identify potential areas where new risks might arise; and secondly, by narrowing the focus to those parts of the system where maturity/liquidity transformation, flawed credit risk transfer and/or leverage create important systemic risk. The Financial Stability Board is to develop initial draft recommendations on shadow banking and submit them to the G-20 in the autumn of 2011.

27. Many other regulatory initiatives are being discussed. They include work on over-the-counter derivatives, rating agencies, alternative investment vehicles, consumer finance protection and financial market infrastructures.

28. Along with the reform of traditional microprudential regulation focused on the level of the individual bank, efforts are ongoing to strengthen system-wide oversight and macroprudential policy framework. Macroprudential policies aim to address a system-wide risk by dampening financial system pro-cyclicality and reducing systemic risk concentrations. In addition to some policies to reduce pro-cyclicality that are contained in Basel III, the main strand here is the design and the introduction of various buffers and protections that can act counter-cyclically and contain spillover effects.

29. Besides regulatory reform, supervisory structures also need further improvement. Indeed, the global financial system is largely regulated on a country-by-country basis. Given that some global regulatory authority is, at best, a distant possibility, financial supervision requires a much higher degree of international cooperation and trust, as potential systemic risks are mainly a cross-border phenomenon.

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[19] "Regulatory reform of the global financial system", remarks by William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at a meeting hosted by the Institute of Regulation and Risk, North Asia, Tokyo, 11 April 2011, available from www.bis.org.

[20] Financial Stability Board, "Shadow Banking: Scoping the Issues, A Background Note of the Financial Stability Board", 12 April 2011, available from www.financialstabilityboard.org.

B. Multilateral surveillance and policy coordination

30. Overseeing the world economy to identify possible risks to global financial and economic stability is a core part of the IMF mandate. The financial and economic crisis has highlighted the need to strengthen multilateral surveillance in order to enhance its fairness and effectiveness. It is generally recognized that IMF in its surveillance activities needs to pay more attention to financial sector issues, to policy spillovers, especially those emanating from systemically important countries and financial centres, and to cross-border linkages.

31. An evaluation of the performance of IMF surveillance in the run-up to the global financial and economic crisis by the IMF Independent Evaluation Office[21] found that IMF did not convey a clear message about the urgent need to address financial sector risks. Surveillance paid insufficient attention to risks of spillovers from advanced economies, deteriorating financial sector balance sheets, and financial regulatory issues, and to the credit boom and emerging asset bubbles. According to the Independent Evaluation Office, various factors played a role in the failure of IMF to identify risks and give clear warnings, such as analytical weaknesses, organizational impediments, internal governance problems and political constraints.

32. IMF has taken steps to improve methods and coverage of its surveillance activities, including increased focus on linkages between the real economy and the financial sector, launching the early warning exercise (in cooperation with the Financial Stability Board) and the Fiscal Monitor, and strengthening the vulnerability exercises. Also, it has been agreed to initiate a trial spillover analysis for the five major economies (China, the Euro area, Japan, the United Kingdom and the United States) that are to be presented alongside article IV consultations in the summer of 2011. At the spring meetings of IMF and the World Bank in April 2011, it was decided to further strengthen the Fund's global monitoring role. In this context, IMF will prepare a new consolidated multilateral surveillance report, which will include analysis of potential spillover effects and will draw on a wider range of information.[22]

33. IMF and the World Bank have also revamped the Financial Sector Assessment Programme, including through the decision by IMF to make financial stability assessments under the Financial Sector Assessment Programme a mandatory part of surveillance for the 25 jurisdictions with systemically important financial sectors every five years. Financial sector surveillance is not the purview of the Fund alone. Accordingly, collaboration with other relevant institutions, such as the Financial Stability Board, the Bank for International Settlements and financial sector standard-setting bodies, continues to be a priority.

34. Effective surveillance is constrained by the lack of a mechanism to enforce policy adjustments in countries. To increase the traction of the IMF surveillance mandate, a group of former senior international policymakers suggested to strengthen the international commitment to consider the impacts of domestic

[21] International Monetary Fund, Independent Evaluation Office, "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-07", 2011, available from www.ieo-imf.org.

[22] International Monetary Fund, "New Emphasis on IMF's Global Monitoring Role", *IMF Survey Magazine*, 17 April 2011, available from www.imf.org.

policies on global stability.[23] The group proposed to develop norms on economic and financial policies, which might cover, for example, current account deficits or surpluses, inflation rates, or fiscal deficits and debt ratios. Breach of a norm would trigger a consultation procedure. In case of compliance or non-compliance of countries with internationally agreed policy norms, the group also proposed to create the possibility of incentives and sanctions.

35. It is recognized that economic policy coordination within the G-20 during the crisis was instrumental in averting an even more serious downturn and in setting the stage for recovery. In 2009, G-20 leaders launched the *Framework for Strong, Sustainable, and Balanced Growth*, through which G-20 countries identify objectives for the global economy and the policies needed to reach them. The framework includes a mutual assessment process to evaluate progress towards meeting the shared objectives. However, as global recovery continues, the cooperative spirit among policymakers in the major economies appears to have been waning, and national considerations are regaining priority over multilateral efforts.[24] Against this background, as well as in the broader context of strengthening governance for sustainable development, it is critical that macroeconomic policy coordination be sustained, strengthened and institutionalized on the multilateral agenda.

36. In November 2010, G-20 leaders, at their summit in Seoul, reaffirmed their commitment to strengthen multilateral cooperation, to promote external sustainability and to pursue policies conducive to reducing excessive imbalances. In this regard, the G-20 leaders noted the importance of assessing, against indicative guidelines, the nature of persistently large imbalances and the root causes of impediments to adjustment as part of the mutual assessment process, while recognizing the need to take into account national and regional circumstances.[25]

37. The challenge still remains to make the G-20 policy framework for sustainable global rebalancing more specific and operational. Clear and verifiable targets will need to be laid out to put the global economy on a development path that is both more balanced and sustainable.

38. While most of the smaller countries may have limited systemic importance for the world economy, and are excluded from the G-20 process, issues under discussion at the G-20 nevertheless have profound implications for their economies. Therefore, this informal grouping needs to forge stronger institutional linkages with non-member States and universal international bodies, in particular the United Nations.

39. While the mutual assessment process is outside of the IMF surveillance process, the Fund provides supporting technical analysis in assessing policies and identifying focus areas that require action. In the future, a stronger role of the Fund

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[23] Palais-Royal Initiative, "Reform of the International Monetary System: A Cooperative Approach for the Twenty First Century", 2011, available from www.elysee.fr. The group was convened by Michel Camdessus, Former Managing Director, IMF; Alexandre Lamfalussy, Former General Manager, BIS; and Tommaso Padoa-Schioppa, Former Minister of Finance, Italy, and comprised a number of other former senior policymakers.

[24] "Assessing the Agenda for Economic Policy Cooperation", speech by John Lipsky, IMF First Deputy Managing Director, at the Conference on Macro and Growth Policies in the Wake of the Crisis, Washington, D.C., 7 March 2011, available from www.imf.org.

[25] G-20 Seoul Summit Document, 11-12 November 2010, available from www.seoulsummit.kr.

in global macroeconomic policy coordination might be envisaged, drawing from the experiences of both the mutual assessment process and the regular IMF surveillance, including spillover reports, and exploring synergies between these, largely complementary, processes. There is also a need for clearer procedures and practices to ensure complementarity of policy coordination efforts between the United Nations, IMF, G-20 and other multilateral stakeholders. The role of the United Nations within the global economic governance framework is primarily to serve as a universally inclusive platform for discussion, coordination and decision-making in addressing, in an integrated manner, global challenges of sustainable development, including those of medium- and long-term nature.

40. Another issue that has taken a centre stage on the policy cooperation agenda is capital flows, in particular the extent and volatility of capital flows to emerging economies. The policy debate on capital flows has focused on the question of how to respond to potentially destabilizing capital inflows and which policy instruments to choose. In designing policy responses, recipient countries have a range of tools at their disposal. Policy options include exchange rate, monetary, fiscal and macroprudential policies and other forms of capital account regulations, such as capital controls.

41. The implementation of capital controls by a country can have multilateral repercussions. In an era of financial globalization, it is no longer possible for any individual country to fully manage cross-border risk by unilateral action. Yet, there is largely a lack of international rules or guidelines on capital flow management. In this context, G-20 leaders called on the Financial Stability Board, IMF and the Bank for International Settlements to do further work on tools to mitigate the impact of excessive capital flows.[25] It has also been emphasized that as capital controls could potentially contravene countries' commitments under the World Trade Organization's General Agreement on Trade in Services, the World Trade Organization should be involved in multilateral policy coordination. In addition, regional and subregional cooperation might be useful to mitigate the adverse impact of capital flows.

42. IMF is working to develop a framework to help countries deal with large capital inflows. As a first step, recent country experiences and potential policy tools to manage capital inflows were examined.[26] The ultimate goal of the framework is to assess policy options for capital flow management, taking into account countries' economic and financial capacity and characteristics, and to determine the appropriate circumstances for the respective measures.

43. Policy advice and cooperation on capital flows should be even-handed and target not only recipient countries, but also originating countries, taking into account their responsibilities for global financial stability. In this regard, it has been argued that boom-bust cycles of capital flows, driven by macroeconomic conditions in advanced economies, may have a detrimental impact on development.[27]

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[26] International Monetary Fund, "Recent Experiences in Managing Capital Inflows: Cross-Cutting Themes and Possible Policy Framework", 14 February 2011, and IMF Staff Discussion Note, "Managing Capital Inflows: What Tools to Use?", 5 April 2011, available from www.imf.org.

[27] Yilmaz Akyuz, "Capital Flows to Developing Countries in a Historical Perspective: Will the Current Boom End with a Bust?", South Centre Research Paper 37, March 2011, available from www.southcentre.org.

C. Coping with developed country sovereign debt crisis

44. Public finances in developed economies have come under significant pressure in the course of the financial crisis. Debt ratios continue to rise in most advanced economies and financing needs are at historical highs.

45. The related loss of confidence in the ability to service public debt, which so far has been most evident in several euro area countries, and the significant exposure of the financial sector to sovereign debt risks represent an important source of instability for the global financial system. According to the IMF *Global Financial Stability Report*, sovereign funding is among the most pressing challenges ahead.[28]

46. To address sovereign debt crisis in Europe, European leaders have agreed on assistance measures to distressed euro area member States. To provide temporary financial support, the European Financial Stability Facility was created in May 2010, with a capacity of up to €440 billion (about $630 billion). It was also agreed to set up a permanent crisis management framework due to be implemented in 2013, the European Stability Mechanism, with an effective lending capacity of €500 billion (about $790 billion). European Union assistance programmes will be complemented by IMF facilities.[29]

47. In the context of the sovereign debt crisis in Europe, the possibility of debt restructuring for troubled countries is being debated. If deemed necessary to preserve financial stability, such measures would need to be adopted and implemented in coordination with all stakeholders concerned.

48. One factor compromising international financial stability against the background of substantial public debt is the absence of an international framework for sovereign debt restructuring. The lack of such a mechanism amplifies market uncertainty in times of public debt crises and complicates debt resolution. There have been many proposals to develop some form of a fair and internationally accepted workout mechanism for official debt obligations of developed and developing countries that applies to all creditors.[30] Such a mechanism is a critical element for the stability of the international financial system. However, thus far there has been no progress on this issue.

49. With a view to safeguarding international financial stability, there is a need to pursue fiscal consolidation in major advanced economies over the medium and long term. G-20 leaders have recognized this need and agreed to address fiscal consolidation within their policy cooperation agenda.[31] Measures to ensure medium-term fiscal sustainability should be internationally coordinated and well timed so as not to damage recovery prospects.

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[28] IMF, *Global Financial Stability Report, Market Update* (Washington, D.C., June 2011).

[29] "The Euro area — challenges and responses", speech by Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Economic Club, New York, 18 April 2011, available from www.bis.org.

[30] For a discussion of international debt contractual arrangements and resolution, see, for instance, *World Economic and Social Survey 2010: Retooling Global Development* (United Nations publication, Sales No. E.10.II.C.1), pp. 126-127.

[31] See, for instance, G-20 Seoul Summit Leaders' Declaration, 11-12 November 2010, available from www.seoulsummit.kr.

D. Global financial safety net

50. An effective global financial safety net is an important backstop for the preservation of global economic and financial stability. Currently, countries rely on a hybrid system of financial safety, combining reserve accumulation, bilateral agreements, and regional and multilateral mechanisms.

51. The international financial safety net was strengthened during the recent crisis and its aftermath. In 2010, IMF increased the duration and credit available under the existing Flexible Credit Line, an insurance option for countries with very strong policies and economic fundamentals, and established a new Precautionary Credit Line. The Precautionary Credit Line, a form of contingency protection, is designed for those countries that do not qualify for the Flexible Credit Line, but have only moderate vulnerabilities. Unlike the Flexible Credit Line, the Precautionary Credit Line features ex-post conditionalities focused on reducing any remaining vulnerabilities identified in the qualification assessment.

52. Resources available to IMF to carry out its lending activities have increased significantly. The Fourteenth General Review of Quotas was completed in December 2010, with a decision to double the IMF's quota resources to approximately $750 billion, and is now awaiting ratification by the membership. Borrowing arrangements with member countries and central banks have also been enhanced. The expanded and more flexible New Arrangements to Borrow with a total borrowing capacity of about $580 billion became operational in March 2011. In order to ensure the capacity of the Fund to provide large-scale liquidity support in the future, its resource base may need to be further enlarged. To this end, there are proposals to fund IMF crisis lending facilities by issuing special drawing rights.

53. While the cooperative efforts during the crisis have strengthened the global financial safety net, important issues remain regarding the sufficiency and composition of international liquidity support. Indeed, the crisis highlighted the need for large liquidity buffers to deal with fast and sizeable capital market swings. This requires further strengthening the multilateral capacity to cope with shocks of a systemic nature. In this regard, it has been stressed that in the recent crisis, the bulk of the needed liquidity was provided through ad hoc arrangements deployed on a one-off basis by key central banks.[32] It has also become evident that uncertainties about the availability and functioning of financial safety nets can impose significant costs.[24]

54. There are a number of suggestions on how to make the global financial safety net more effective and predictable. An ambitious proposal is to develop IMF towards an international lender of last resort, which would provide access to liquidity when no other lender is willing to lend in sufficient volume to deal effectively with a financial crisis.[33] Countries could qualify for access to this facility through the regular article IV IMF surveillance without additional conditions. The liquidity would need to be largely provided by countries issuing

[32] International Monetary Fund, Statement by the Managing Director to the International Monetary and Financial Committee on the Fund's Policy Agenda, 13 April 2011, available from www.imf.org.

[33] See, for instance, Eduardo Fernández Arias and Eduardo Levy Yeyati, "Global Financial Safety Nets: Where Do We Go from Here?", Inter-American Development Bank Working Paper Series No. 231, November 2010.

reserve currencies. Due to the far-reaching obligations of major central banks to grant access to liquidity when the facility is triggered, this proposal will be difficult to implement.

55. IMF itself is exploring related options to set up a permanent mechanism to provide liquidity in systemic crises in conjunction with bilateral and regional liquidity support arrangements.[34] Alternative modalities for such a global stabilization mechanism are under consideration, providing varying degrees of predictability and efficacy. Key elements of the mechanism would need to be defined, such as procedures for activating the mechanism, access to and approval of financing, the instruments involved, the funding of the mechanism, the coordination with relevant central banks and regional arrangements, and safeguards to reduce moral hazard. As a more pragmatic alternative, IMF could take on the role as manager or coordinator of a multilateral network of central bank swap and liquidity lines.

56. A key element in strengthening the global financial safety net is closer cooperation with regional and subregional mechanisms. Regional financial arrangements, such as the Arab Monetary Fund, the Chiang-Mai Initiative, stabilization facilities within the European Union, or the Latin American Reserve Fund, can play an important role in preventing and mitigating financial crises. Ways to improve collaboration and consistency between global and regional facilities should be further explored.

E. Role of special drawing rights

57. The need for reforming the international reserve system has gained wide recognition. Despite some diversification, the majority of reported international foreign exchange reserves continues to be held in United States dollars.[35] In the current system, reserve-issuing countries run external deficits to supply reserve assets, inherently sustaining global economic imbalances, as discussed above. Moreover, the use of national currencies as international reserve assets exposes the global reserve system to vulnerabilities stemming from domestic monetary and economic policies of the reserve-issuing countries.

58. The diversification of the international reserve system towards a multicurrency system might be regarded as a step to better reflect today's multipolar global economy. However, such a system may bear the risk of even higher exchange rate volatility, owing to the possibility of sharp shifts of international demand from one international currency to another.

59. In order to mitigate the possible flaws of a national currency-based reserve system, there are proposals to strengthen the role of the special drawing rights. Strengthening the role of special drawing rights might help reduce the extent and costs of international reserve accumulation; augment the supply of safe global assets and facilitate diversification; and lessen exchange rate volatility among major currencies.

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[34] International Monetary Fund, "The Fund's Mandate — The Future Financing Role: Reform Proposals", 29 June 2010, available from www.imf.org.

[35] The proportion of United States dollars in global foreign currency reserves, as reported to IMF, has declined by about 10 percentage points over the past decade to a little over 60 per cent (IMF, Currency Composition of Official Foreign Exchange Reserves (COFER database), available from www.imf.org).

60. The role of special drawing rights is currently very limited. Although initially designed as "the principal reserve asset in the international monetary system",[36] existing special drawing rights represent less than 4 per cent of total global reserve holdings.[37] Realistically, strengthening the role of special drawing rights as a reserve asset will therefore be a gradual process over the coming years towards a system that combines increased use of special drawing rights with a range of nationally supplied reserve assets. Progress in this direction will require a number of measures to enhance the acceptance, the availability and the use of special drawing rights.

61. Increasing the acceptance of special drawing rights may require broadening the composition of the special drawing right basket to make it more representative. In particular, the inclusion of emerging market currencies should be considered. All the component currencies, however, should be fully convertible and have well-developed financial markets. The International Monetary and Financial Committee, at its meeting in April 2011, called for further work on a criteria-based path to broaden the composition of the special drawing right basket,[38] and work is under way at the Fund on the role and composition of this reserve asset.

62. The amount of special drawing rights allocated increased almost tenfold during the financial crisis (from about SDR 21 billion to currently about SDR 204 billion, equivalent to about $331 billion). For special drawing rights to take on a more significant role, their availability would have to be further increased. This could be achieved through regular — e.g., annual — issuances, taking into account the global demand for reserves. It is estimated that annual issuance of the equivalent of about $200 billion would lift the proportion of special drawing rights in total reserves to a little over 13 per cent after 2020.[37]

63. The possibility of setting up a mechanism that allows countries to convert reserves into special drawing right-denominated securities and deposits could be revisited. This issue was discussed when the substitution account was negotiated within IMF in the 1970s. At that time, countries could not agree on a burden-sharing arrangement regarding the resulting exchange rate risk. Bearing this in mind, it has been suggested to explore alternative designs for a substitution account.[23]

64. One reason for the limited role of special drawing rights at present is that they are not used in private commercial or financial transactions. Developing a market for special drawing right-denominated financial instruments might involve issuance of special drawing right-denominated bonds by sovereigns and multilateral financial institutions, to the extent possible without significantly increasing borrowing costs. In addition, IMF could consider using special drawing rights in its lending activities.

65. The measures to promote the use of special drawing rights as a unit of account may include the pricing of international trade, such as trade in commodities, pegging currencies, and reporting international statistics, such as balance of payments or other data.[37] Consideration might also be given to increase the use of special drawing rights as a reference unit in international organizations and

[36] International Monetary Fund Articles of Agreement, art. VIII, sect. 7.

[37] International Monetary Fund, "Enhancing International Monetary Stability — A Role for the SDR?", 7 January 2011, available from www.imf.org.

[38] International Monetary Fund, International Monetary and Financial Committee, Communiqué of the twenty-third meeting, 16 April 2011, available from www.imf.org.

agreements, such as is currently practised in IMF, the Universal Postal Union and the Convention for the Unification of Certain Rules for International Carriage by Air (1999).[39]

F. Governance reform at the Bretton Woods institutions

66. Both IMF and the World Bank have taken steps to redress imbalances in terms of voice and representation. The recent governance reforms aim at better reflecting today's composition of the world economy and moving towards a more representative, responsive and accountable governance structure.

67. The second phase of governance reform for the World Bank Group, agreed upon in April 2010, foresees a shift in voting power to developing and transition countries in the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC) and the International Development Association (IDA), with a commitment to move, over time, towards equitable voting power. The reform increases the voting power of developing countries and countries with economies in transition by an aggregate 4.59 percentage points in IBRD (since 2008) to 47.19 per cent; by 6.07 percentage points in IFC to 39.48 per cent; and by about 6 percentage points in IDA to 45.59 per cent.

68. The IMF 2008 quota and voice reforms, basically involving quota redistribution among a group of emerging market and developing countries, the tripling of the basic votes, and an appointment of a second Alternate Executive Director in the constituencies of seven or more members, entered into force on 3 March 2011. The 2008 reform was followed by further, more significant, changes in 2010.

69. In December 2010, the IMF Board of Governors approved quota and governance reforms under the Fourteenth General Review of Quotas. The reforms will double member countries' quotas. They will also shift more than 6 per cent of quota shares to emerging market and developing countries without lowering the quota shares and voting power of the poorest members. The 2010 reforms also envisage an all-elected Executive Board with increased representation of developing countries while keeping the size of the Board unchanged. The International Monetary and Financial Committee, at its meeting in April 2011, urged all members to make the 2010 quota and governance reforms effective by the 2012 annual meetings.[38] In addition, a comprehensive review of the current quota formula is scheduled to be completed by January 2013, which might give greater weight to variables supporting the representation of developing countries.

70. While recent measures represent important progress, efforts to further enhance the governance structure of the Bretton Woods institutions should continue. It is considered important to clarify the roles and responsibilities of the management and the Executive Boards of both organizations to improve accountability and effectiveness. It has also been suggested to increase the roles of the International Monetary and Financial Committee and the Development Committee in strategic decision-making. In this regard, many developing countries are of the view that these bodies should retain their advisory nature and consensus-based character.[40]

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[39] United Nations, *Treaty Series*, vol. 2242, No. 39917.

[40] Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development, Communiqué 14 April 2011, available from www.imf.org.

The introduction of an open and transparent senior leadership selection process that is based on merit irrespective of nationality and gender as well as the promotion of greater management and staff national diversity are still important goals.

III. Conclusions

71. **Important priorities in financial regulation are the implementation of Basel III, new rules for systemically important financial institutions and adequate regulation of the shadow banking system. It is vital to discourage attempts to achieve a national competitive advantage in the process of regulatory reform and to ensure that regulations and their implementation as well as supervisory practices are driven by the goal of bolstering global financial stability and development, rather than by interests of some narrow group of private financial institutions and/or markets.**

72. **IMF in its surveillance activities needs to pay more attention to spillovers of major countries' policies on the rest of the world. Enhancing international coherence and promoting coordination among national economic policies towards improved financial stability and sustainable global growth should become a central objective of the IMF agenda.**

73. **In the aftermath of the financial and economic crisis, capital flows have taken a centre stage in the policy debate on global economic and financial stability. In the era of financial globalization, there is a need for some form of international framework for assessing policies to manage cross-border capital flows.**

74. **Rising public debt in developed countries has increasingly been perceived as a major source of instability for the global financial system. To address this issue, there is a need to ensure medium-term fiscal sustainability without destabilizing financial markets. It has also been suggested to develop an international framework for sovereign debt restructuring.**

75. **Despite recent initiatives to strengthen the global financial safety net, there is scope for further enhancing multilateral liquidity provision. There might be a case to consider the creation of a multilateral mechanism to provide financing in systemic crises, in conjunction with bilateral and regional liquidity support arrangements.**

76. **The need to explore options for reform of the international monetary system is now broadly accepted. In particular, enhancing the role of special drawing rights in moving towards a more balanced and stable global reserve system should be kept under consideration.**

77. **The Bretton Woods institutions have taken important steps to redress imbalances in voice and representation. Along with the timely and thorough implementation of the agreed reforms, it is important to continue work on various governance issues, including on further improving the governance structure, enhancing the diversity of management and staff and developing open, transparent and merit-based selection processes for senior leadership.**